

**STATE BOARD OF EQUALIZATION**

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August 7, 1995

Mr. C--- E. K---
S--- R--- C---, Inc.
P. O. Box XXXXX
--- ---, CA XXXXX-XXXXX

Re: **S--- R--- C---, Inc.**
SZ - XX-XXXXXX

Dear Mr. K---:

This is in response to your letter dated May 30, 1995 requesting reconsideration of our opinion dated May 8, 1995 on how tax applies on the sale of computer software included in your company's sales of Computerized Branch Exchange ("CBX") systems. This letter supersedes and replaces our opinion to you dated May 8, 1995.

Our understanding of the facts surrounding your inquiry is based on your March 9, 1995 and May 30, 1995 letters to us. S--- R--- ("SR") sells computerized telephone switching systems known as CBX. Your March 9, 1995 letter states:

"Each CBX is configured to meet the customer's unique requirements. The number of lines, the actual extension numbers, and the type of device on each line (console, terminal, plain phone, featured phone, etc.) must be embedded in the CBX software. So too, the public phone network system trunk, carrier (AT&T, MCI, Sprint), WATS, FX, or TIE lines which are to be connected to the CBX must also be programmed. There might be connections to other CBXs forming an intra-organization network. Further, the CBX has a myriad of optional, extra cost features (such as Automatic Call Distribution), which require software applications, others which are software themselves.

"To generate this unique software, the installation parameters (CBX model, lines, devices, options, etc....) are coded into input sheets by Customer Installation Specialists working closely with the customers and by software generation

specialists employed as S--- R--- headquarters. These input sheets are keyed into [a] PC program named DCT (Data Collection Tool) which is located at each S--- R--- branch office. Once the software has been input and validated, using the parameters defined, it is sent to the S--- R--- Reference Center, located in S--- C-- -. These special programs create the appropriate template to produce a customized software package for the specific installation. This customized version, usually in the form of DAT tape, is then thoroughly tested before being delivered with the hardware for installation at the customer's site by our technicians. Our on-site technicians then thoroughly test the software again after installation."

Your May 30, 1995 letter provides additional information regarding SR's CBX software:

"The CBX software to which we are referring is non-functional without the customization performed by our programmers. The programming includes number of lines, extension numbers, carrier lines, the keyboard layout, type of ring, and any and all of a myriad of features that make each switch functional. Without extensive programming, the product has little value and cannot be used in any manner (i.e. 'a lump of clay')...."

You ask that we reconsider the conclusion reached in our opinion letter to SR dated May 8, 1995 based on the additional information you provided to us about SR's CBX software.

Discussion

As a starting point, we are unable to provide opinions which conclusively make a transaction not subject to tax where the application of tax depends on the actual facts surrounding the transaction. Instead, we provide opinions on how tax applies in particular situations based on the factual representations provided to us by the taxpayer. How tax applies in any "fact-based" situation ultimately depends on the actual facts regarding the product transferred (or the circumstances involving the transfer itself) and are always subject to review and analysis during an audit and subsequent administrative review. SR's sales of CBX software require an analysis of facts in order to determine how (or whether) tax applies since it must be determined whether the software constitutes a "basic operational program" or a "custom computer program" as discussed below. As such, we are only able to comment on how tax applies based on stated facts and assumptions and cannot guarantee that, upon audit, a Board Auditor will not conclude that the facts are different from the facts and assumptions on which this letter is based.

Subdivision (f) of Regulation 1502 addresses the application of tax to sales of computer programs. As set forth in our previous letter, subdivision (f)(2) of Regulation 1502 provides:

"(A) Tax does not apply to the sale or lease of a custom computer program, other than a basic operational program, regardless of the form in which the program is

transferred. Nor does the tax apply to the transfer of a custom program, or custom programming services performed, in connection with the sale or lease of computer equipment, whether or not the charges for the custom program or programming are separately stated.

"(B) However, charges for custom modifications to prewritten programs are nontaxable only if the charges for the modifications are separately stated. Otherwise, the charges are taxable as services part of the sale of the prewritten program.

"When the charges for modification of a prewritten program are not separately stated, tax applies to the entire charge made to the customer for the modified program unless the modification is so significant that the new program qualifies as a custom program. If the prewritten program was previously marketed, the new program will qualify as a custom program, if the price of the prewritten program was 50 percent or less of the price of the new program. If the prewritten program was not previously marketed, the new program will qualify as a custom program, if the charge made to the customer for custom programming services, as evidenced in the records of the seller, was more than 50 percent of the contract price to the customer.

"...."

This provision specifies that tax applies to the sale of a basic operational program whether or not that program is custom. (See also Rev. & Tax. Code § 6010.9.) A "basic operational program" means, among other things, a computer program which is fundamental and necessary to the functioning of a computer and includes supervisors, monitors, executives and control or master programs which consist of the control program elements of that system. (Rev. & Tax. Code § 995.2.) Thus, tax applies to SR's sale of its CBX software if this software constitutes a basic operational program regardless of the amount of customization performed on that software. For the remainder of this opinion, however, we assume that SR's CBX software is not a basic operational program.

We understand that SR substantially modifies prewritten software consisting of the "skeletal" make-up for all CBX systems in order to provide its customers with a unique CBX system. Pursuant to Regulation 1502(f)(2), tax does not apply to SR's charges for modifying this software when these charges are separately stated on the sales invoice to its customers. (In this type of situation, tax applies to the charges for the prewritten software but not to the charges for software modification.) When the charges for customizing the software are not separately stated, tax does not apply to SR's sale of the modified software only if the charge for customizing the software is more than 50 percent of the contract price for the CBX software.

We assume that SR does not separately state its charges for modifying the "skeletal" software for its CBX systems. In that regard, you state that the "skeletal" software is a non-

functional "lump of clay" with little value in the absence of extensive programming performed by your company. We understand this to mean that the prewritten software on which each unique CBX system is based is so extensively modified that SR's charges for customizing the software exceed 50 percent of the contract price of the software sold to its customers. Under these facts, the modified software qualifies as a custom program within the meaning of Regulation 1502(f)(2), and its sale is not subject to tax. However, if the charges for modification are not equal to or greater than the charge allocable to the prewritten program, tax applies on SR's entire charge for the sale of the software.

Our opinion above is based on the facts, representations, and conclusions you have provided to us regarding SR's CBX software. Our response might be different in the event that any of these facts, representations, or conclusions are not as stated.

If you have any further questions, please write again.

Sincerely,

Warren L. Astleford
Staff Counsel

WLA:cl

cc: --- --- District Administrator